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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
1997 Annual Access Tariff Filings	)	**CC Docket No. 97-149**
	)	

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MCI OPPOSITION TO DIRECT CASES

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SUMMARY

MCI respectfully requests that the Commission require the price cap LECs to revise their BFP forecasts to reflect historical trends, and to revise their computation of the equal access expense exogenous cost change to reflect the change in "R" value since the inception of price cap regulation.

Application of the Bureau's "report card" methodology shows that, without exception, the LECs' BFP forecasting techniques must be given a failing grade. Given this record of forecasting error, the Commission should require revision of any price cap LEC BFP estimates that depart from the historical trend. In particular, the Commission should require revision of any BFP estimates that are significantly below trend. The record shows that the price cap LECs' forecasting errors have generally taken the form of underestimating the BFP. The Commission should, at a minimum, require the four LECs whose forecasts depart most significantly from the historical trend, BellSouth, SWBT, U S West, and GTE, to revise their 1997-98 BFP forecasts and SLC and CCL rates.

The Commission should require the price cap LECs to compute the exogenous cost adjustment for the completion of equal access expense amortization by multiplying the 1990 equal access revenue requirement by the ratio of the 1996 R value to the R value at the inception of price caps. Only an R value adjustment can ensure that today's rates for traffic sensitive basket services are no higher than if the equal access expense amortization component had not been included in the switched access basket on January 1, 1991.

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MCI OPPOSITION TO DIRECT CASES

I. Introduction

MCI Telecommunications Corporation (MCI), pursuant to the Designation Order in the above-captioned docket, hereby submits its Opposition to the Direct Cases filed by the price cap LECs on September 2, 1997. The LECs' Direct Cases respond to three issues set for investigation in the Suspension Order:[1] the reasonableness of the LECs' BFP forecasts, the reasonableness of the LECs' methodology for removing the effects of the equal access expense amortization from their price cap indexes (PCIs), and certain price cap LECs' computation of exogenous cost changes resulting from changes to the separations rules governing OB&C expenses. MCI respectfully requests that the Commission require the price cap LECs' to revise their BFP forecasts to reflect historical trends, and to revise their computation of the equal access expense exogenous

[1]In the Matter of 1997 Annual Access Tariff Filings, Memorandum Opinion and Order, CC Docket No. 97-149, June 27, 1997 (Suspension Order).

cost change to reflect the change "R" value changes since the inception of price cap regulation.

II. BFP Issues

In the Suspension Order, the Bureau found that LECs' BFP forecasts raised substantial questions of lawfulness that warranted investigation.[2] Accordingly, the Designation Order requires the price cap LECs to provide detailed information concerning their BFP forecasting methodology and the accuracy of their BFP forecasts in the past.[3] The information provided by the LECs in their direct cases demonstrates that the Commission should require significant revisions to the price cap LECs' 1997-98 BFP forecasts and, consequently, their SLC and CCL rates.

A. The LECs' Forecasts Are Inconsistent With Historical Trends

With only a few exceptions, the price cap LECs' 1997-98 forecasts are inconsistent with historical trends. As shown in Attachment A, the aggregate BFP forecast by the price cap LECs[4] is approximately $487 million less than a BFP forecast computed using the average growth rate for the six years of price cap regulation; $457 million less than a BFP forecast computed using the average growth rate for the most

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[2]Suspension Order at ¶22.

[3]In the Matter of 1997 Annual Access Filings, Order Designating Issues for Investigation, CC Docket No. 97-149, July 28, 1997, ¶¶13-34.

[4]Here, "price cap LECs" refers to the BOCs and GTE.

recent three years; and $632 million less than a BFP forecast developed from regression analysis. Thus, by any measure of historical trends, the LEC's 1997-98 forecasts are below trend.

While several price cap LECs are forecasting below-trend BFPs, the aggregate deviation from trend is driven in large part by the unusually low BFP forecasts of four LECs. SWBT's BFP forecast is $116.6 million below trend because it is forecasting a 3.78 percent decline in its BFP after recording BFP growth rates of 5.03 percent, 8.21 percent, and 10.27 percent in the past three tariff years.[5] Similarly, U S West's BFP forecast is $156.0 million below trend because it is forecasting a 1.98 percent decline in its BFP for 1997-98 after recording BFP growth rates of 14.17 percent, 7.18 percent, and 9.03 percent in the past three tariff years.[6] GTE and BellSouth's forecasts are also well below trend, as they assume that the low BFP growth rate they recorded in 1996-97 is not simply a one-time event.

B. The Commission Should Require the LECs to Revise Their BFP Forecasts

In the context of past annual access filings, the Common Carrier Bureau (Bureau) has required revision of forecasts that departed significantly from the historical trend. Most recently, in the 1990 Annual Access Order,[7] the Bureau employed a two-part

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[5]See Attachment A, p. 8; Attachment B, p. 8.

[6]See Attachment A, p. 9; Attachment B, p. 9.

[7]In the Matter of Annual 1990 Access Tariff Filings, Memorandum Opinion and Order, 5 FCC Rcd 4177 (1990 Annual Access Order).

analysis, first evaluating the accuracy of past LEC forecasts and then, for LECs whose past forecasts were inaccurate, requiring revision of forecasts that departed significantly from the trend.

In the 1990 Annual Access Order, the Bureau used a "report card" methodology to evaluate the accuracy of the LECs' forecasting techniques.[8] The Bureau computed a weighted average of forecasting errors for the three most recent tariff years and then determined whether the weighted average of the forecasting errors exceeded a threshold level of one percent. Application of the Bureau's report card methodology to the LECs' BFP estimates shows that, without exception, the BOCs' forecasting techniques must be given a failing grade. As shown in Attachment B, every BOC's weighted average forecasting error exceeds 1.5%, and several BOCs' weighted average forecasting errors exceed 5 percent.[9] Even if a more lenient 2% or 5% pass/fail standard is employed, the forecasting techniques of nearly all of the BOCs would still be given a failing grade.

Given this record of forecasting error, the Commission should require revision of any price cap LEC BFP estimates that depart from the historical trend. In particular, the Commission should require revision of any BFP estimates that are significantly below trend. As shown in Attachment A, the price cap LECs' forecasting errors have, almost without exception, taken the form of underestimating the BFP. The BOCs alone have underestimated their BFP by almost $2 billion since the inception of price cap

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[8] 1990 Annual Access Order, 5 FCC Rcd at 4199-4200.

[9] No report card is provided for GTE, as GTE has changed forecasting methodologies for this annual filing.

regulation,[10] and most price cap LECs have underforecasted their BFP in at least five of the past six annual access filings. In most tariff years, the BOCs have underforecasted the BFP by about \$300-\$400 million, the amount by which their 1997-98 forecasts are below trend. In light of the LECs' history of inaccurate forecasts, and the clear pattern of underforecasting the BFP, BFP estimates that are below trend should be presumed inaccurate and revised to reflect levels consistent with trend.

None of the price cap LECs that is forecasting a below-trend 1997-98 BFP has presented an explanation sufficient to overcome a presumption that their below-trend forecast is inaccurate. SWBT and U S West, both of which are forecasting a BFP that is significantly below trend, rely on a "bottoms-up" methodology based on forecasts of future company budgets. With this methodology, below-trend BFP forecasts result from forecasts of expected reductions in company expenses.[11] The record, however, shows that these savings rarely materialize. The LECs' explanations of past forecasting errors in their direct cases show that the primary reason for the pattern of underforecasts is simply that their actual expenses or investment usually exceed expected levels.[12] SWBT and U S West both forecasted declines in their BFP in each of the last two annual filings, only to see their BFP <u>increase</u> by almost 10 percent. The Commission should require

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[10]<u>See</u> Attachment A, p. 1.

[11]<u>See</u> U S West Direct Case at 15 ("The 1997 forecast is inconsistent with the historical pattern. This is due to the prediction by budget experts that expense levels to be generated by the Company would come in at a different level in 1997 and 1998 than the historical pattern.")

[12]<u>See</u>, <u>e.g.</u>, U S West Direct Case at 8.

revision of below-trend BFP forecasts that are based only on hoped-for efficiencies or savings.

GTE's forecast is approximately $120 million below trend because it assumes that an unprecedented 5.3 percent decline in its BFP recorded in 1996 will be repeated. GTE developed its 1997-98 forecast by determining the BFP change between 1995 and 1996, and then applying this same percentage change to 1996 data to arrive at a 1997-98 forecast.[13] As the Bureau noted in the Suspension Order, it has found in the past that it is difficult to predict an accurate BFP trend line based on just two years of data.[14] While no forecasting technique is completely accurate, the use of two years' of data will accentuate forecasting errors when there is year-to-year variation in BFP growth rates, as is the case with GTE. GTE's past forecasting record provides no basis for evaluating its two-year trend approach, as this is the first year that it has employed the two-year trend approach.[15] However, given that a 5 percent decline in BFP is almost unprecedented among the price cap LECs, and that no LEC has ever recorded such a decline two years in a row, GTE's forecast is clearly unreasonable. Moreover, on an individual study area basis, GTE's forecast leads to BFP forecasts that are even more implausible. For example, GTE is forecasting that the BFP for California (GTCA) will decline by over 10 percent for the second year in a row.[16]

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[13]GTE Direct Case, Exhibit A-9, p. 2.

[14]Suspension Order at ¶10.

[15]GTE Direct Case, p. 13 (previously, GTE used a "bottoms-up" approach).

[16]GTE Direct Case, Exhibit A-9, p. 1.

Revision of the LECs' below-trend forecasts is necessary because continued underforecasting of the BFP would undermine the objectives of the Access Reform Order.[17] One of the primary goals of the Access Reform Order is to align the rate structure more closely with the manner in which costs are incurred by shifting the recovery of NTS loop costs from per-minute CCL charges to flat-rated charges.[18] The Commission found that the current per-minute CCL represents an economically inefficient cost-recovery mechanism and implicit subsidy.[19] If LECs consistently underforecast the SLC, more revenues need to be recovered through the combination of the PICC and CCL, which will delay the date on which the CCL is phased out. Because this delay would allow the continuation of the implicit subsidy that the Access Reform Order seeks to eliminate, the Commission should require revision of any BFP forecasts that are significantly below trend, if the LEC has demonstrated a consistent pattern of underforecasting and has not provided adequate justification for a below-trend forecast.

The report cards in Attachment B show that, in contrast to their BFP forecasts, the LECs' line forecasts have been relatively accurate. In addition, the LECs' 1997-98 line count forecats are consistent with historical trends. For these reasons, no revision of the LECs' line forecasts is required.

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[17]In the Matter of Access Charge Reform, First Report and Order, CC Docket No. 96-262 (Access Reform Order).

[18]Access Reform Order at ¶37.

[19]Id. at ¶69.

III. Equal Access Amortization Issues

In the Access Reform Order, the Commission directed the price cap LECs to make a downward exogenous adjustment to the traffic sensitive basket to account for the completed amortization of equal access expense.[20] The Commission concluded that ratepayers should not be forced to pay for a cost that, were it not for the way price cap regulation occurred, they would no longer be paying.[21]

In their annual access filings, the price cap LECs generally employed a two-step process to calculate their exogenous cost change. First, the LECs determined the portion of equal access revenues at the initiation of price cap regulation that constituted the expenses subject to the special amortization. Then, the LECs reduced these amounts by the amount of the PCI change between January 1, 1991 and June 30, 1997. Bell Atlantic, for example, estimated a $21.1 million 1990 revenue requirement for equal access amortization, and then multiplied this amount by 78.8807/100.00, the ratio of its June 30, 1996 PCI to the initial PCI.[22]

In the Designation Order, the Bureau tentatively concludes that a revenue adjustment to the amortized equal access expenses, as opposed to a PCI adjustment, is a reasonable method of fully removing the amortized equal access costs from current

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[20] Access Reform Order at ¶314.

[21] Id. at ¶311.

[22] Letter from Maureen Keenan, Bell Atlantic, to William F. Caton, FCC, June 9, 1997, Appendix C.

rates.[23] The Bureau seeks comment on the use of an "R" adjustment, and directs the price cap LECs' that are required to make exogenous adjustments for the expiration of equal access amortization to submit data on the local switching revenue of their traffic sensitive basket as reflected in their initial price cap filings.

A. An "R" Value Adjustment is Necessary to Completely Remove Amortized Equal Access Expenses from LEC Rates

In the Access Reform Order, the Commission emphasizes that ratepayers should not be forced to pay for a cost that, were it not for the way that price cap regulation occurred, they would no longer be paying.[24] In other words, the current PCI must be set to ensure that today's rates for traffic sensitive basket services are no higher than if the equal access amortization rate element had not been part of the switched access basket on January 1, 1991. Inclusion of the equal access rate element in the initial switched access basket, coupled with the pricing flexibility permitted by price cap regulation, allowed the LECs to increase rates for local switching and other elements, most obviously when the LECs set their equal access rate to zero in 1992 or 1993.

Under the price cap rules, PCI adjustments are computed by dividing Delta Z, the exogenous cost change, by R, or Z/R. The fraction of the initial PCI that represented the costs of the equal access amortization can be represented as $Cost_{EA-90}/R_I$. To ensure that the current PCI does not reflect the costs of equal access amortization, the current PCI

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[23]Designation Order at ¶41.

[24]Access Reform Order at ¶311.

must be reduced by the same fraction. Accordingly, Z_{96}/R_{96} must equal $Cost_{EA\text{-}90}/R_I$, and Z_{96} must therefore equal $Cost_{EA\text{-}90}*(R_{96}/R_I)$. Thus, an R value adjustment is required to completely remove amortized equal access expenses from LEC rates. Mathematically, adjusting current indices to fully remove the effects of extraordinary costs reflected in the initial price cap indexes is the same as a sharing reversal. This is not surprising, as the objective in both cases is to return the PCI to its equilibrium level.

Because the composition of the traffic sensitive basket today differs from the composition of the switched access basket at the inception of price cap regulation, unadjusted R values cannot be used to compute Delta Z. However, the local switching service category revenues are a good proxy for the revenues that the traffic sensitive basket would have had in 1990 had it existed as currently constituted. Accordingly, the Commission should require the LECs to compute Delta Z by multiplying the equal access amortization amount included in the initial price cap index by the ratio of 1996 local switching service category revenues to 1991 local switching service category revenues.

Even the LECs appear to recognize that their methodology does not fully remove the effects of amortized equal access expenses from their rates, as most do not attempt to justify their proposed PCI adjustments in their Direct Cases. Ameritech, one of the exceptions, argues that adjusting the initial amortized equal access expense amount for the change in PCI is appropriate because it reflects the "squeezing" of costs by the action of the price cap mechanism.[25] This reasoning ignores the fact that the Commission has concluded that there were no amortized equal access costs left to recover after 1993. Furthermore, the R value adjustment fully reflects the PCI changes.

B. The LECs' Arguments Are Without Merit

The LECs advance several arguments against an R value adjustment. First, they argue that no R value adjustment should be required because the Commission did not specifically provide for such an adjustment in the Access Reform Order. The LECs liken the situation to the one addressed in the 1995 Annual Access Order, when the Bureau declined to order an R value adjustment when OPEB costs were removed from the LECs' PCIs.[26] Bell Atlantic, for example, argues that "as with OPEB, the Commission's underlying order in the Access Reform proceeding did not explicitly require that equal access amortization take into account any changes in revenue that results from growth in demand."[27] However, the Bureau's decision in the 1995 Annual Access Order was based on its determination that the Commission's instruction that each LEC "reduce its PCIs by an amount equal to the exogenous cost adjustment made to reflect the implementation of SFAS-106 for OPEB costs" was unclear.[28] Because the

[25]Ameritech Direct Case at 6.

[26]In the Matter of 1995 Annual Access Tariff Filings of Price Cap Carriers, Memorandum Opinion and Order Suspending Rates, 11 FCC Rcd 5461, 5470-5472 (1995 Annual Access Order).

[27]Bell Atlantic Direct Case at 7.

[28]1995 Annual Access Order, 11 FCC Rcd at 5471, ¶15.

reference to "amount" was ambiguous, and could be interpreted as referring to the dollar amount of the original OPEB exogenous cost adjustment, the Bureau allowed the LECs' tariffs to go into effect without an R value adjustment. Here, by contrast, there is no reference to "amount" or any ambiguity. Nothing in the 1995 Annual Access Order prevents the Commission from requiring the R value adjustment necessary to adjust the PCI for the complete recovery of equal access expenses, as required by the Access Reform Order.

The LECs also argue that no R value adjustment should be required because they did not employ such an adjustment when the inside wiring and reserve deficiency amortizations were completed. They fail to distinguish very different situations. In the case of the inside wiring and reserve deficiency amortizations, the exogenous cost changes were made immediately after the completion of the amortization. It was therefore possible to identify the relevant costs and make appropriate exogenous cost changes. With equal access expenses, by contrast, the costs have been fully recovered since at least the end of 1993. Only a PCI adjustment equal to the costs reflected in the initial PCI, adjusted for the change in R, can ensure that the effects of the equal access expenses are completely removed from the LECs' rates.

V. OB&C Issues

In the Designation Order, the Bureau requires U S West to explain why it is reasonable to make an OB&C exogenous adjustment of $845,145 to recover additional interstate costs incurred during the two-month period between May 1 and July 1, 1997.[29] U S West states only that it "delayed the implementation for efficiency reasons so as not to burden the Commission and the Company with another filing during the heavy annual filing period with its multiple filing requirements."[30]

Regardless of U S West's reasons, the proposed exogenous increase still represents a retroactive rate increase that is prohibited by the filed rate doctrine. U S West made a decision to forego recovering revenues that it was permitted to recover by the Commission's rules, and cannot now recoup these revenues. As U S West notes in its Direct Case, other price cap LECs were able to file exogenous cost increases in May.[31]

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[29] Designation Order at ¶20.

[30] U S West Direct Case at 36.

[31] Id.

V. Conclusion

MCI recommends that the Commission require the price cap LECs' to revise their 1997-98 annual access filings to include BFP forecasts that are consistent with historical trends and to use an R value adjustment to compute the equal access amortization exogenous cost change.

Respectfully submitted,
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September 17, 1997

STATEMENT OF VERIFICATION

I have read the foregoing, and to the best of my knowledge, information, and belief there is good ground to support it, and that it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on September 17, 1997.

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CERTIFICATE OF SERVICE

I, Barbara Nowlin, do hereby certify that copies of the foregoing MCI Opposition to Direct Cases were sent via first class mail, postage paid, to the following on this 17th day of September, 1997.

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Attachment A:

Comparison of LEC Forecasts to Trend

Trend Analysis

This attachment compares the LECs' 1997-98 BFP forecasts to forecasts based on historical growth trends or regression analysis. The annual growth rate was adjusted to derive an 18-month growth rate, which was then applied to the 1996 actual BFP to derive a 1997-98 forecast. In the case of GTE, its Series 2 BFP figures apparently included USF amounts. As a result, the Series 2 data was used to compute historical growth rates, but the growth rate was then applied to the 1996 BFP figure that GTE used in computing its 1997-98 forecast, not the 1996 Series 2 BFP.

TREND ANALYSIS SUMMARY

<u>Variation of LEC Forecasts from Trend</u>

1) 1997-98 BFP Computed Using Average BFP Growth Rate

Trend Forecast BFP - LEC Forecast:

Total:	486,520	below trend
Ameritech	(27,310)	
Bell Atlantic	(4,157)	
BellSouth	**90,398**	
NYNEX	15,918	
Pacific Bell	18,392	
Nevada Bell	(231)	
SWBT	**116,619**	
U S West	**155,960**	
GTE	**120,930**	

2) 1997-98 BFP Computed Using 3 Year Average Growth (94, 95, 96)

Trend Forecast BFP - LEC Forecast:

Total:	456,668	below trend

3) 1997-98 BFP Computed Using Regression Analysis

Trend Forecast BFP - LEC Forecast:

Total:	631,932	below trend